

# **PART I**

## **OVERVIEW OF THE WASHINGTON TAX SYSTEM**

### State and Local Government Revenues

According to survey data compiled by the Census Bureau of the U.S. Department of Commerce, total revenues received by Washington state and local jurisdictions amounted to \$43.8 billion during fiscal year 1999 (see Table 1).

"General" revenues accounted for 72 percent of the total Washington revenues. The expenditure of these revenues is typically determined by the legislative bodies of the various governmental jurisdictions (State Legislature, County Commissioners, City Councils, etc.) via the annual or biennial budget process. Taxes are the most important of the general revenue sources for the state and second to intergovernmental revenues for local governments; they represent 41 percent of total revenues. Other significant revenue sources are charges for services, 12.7 percent, and federal grants, 12.1 percent. Intergovernmental transfers, including state-shared tax revenues, are especially important for local jurisdictions.

Nongeneral revenue sources represent 28 percent of total revenues; these revenues are usually not available for general programs but are often dedicated to specific purposes. Examples include enterprise funds received for municipal utility functions, profits derived from liquor sales, payroll taxes that are dedicated for workers' compensation programs, and contributions for pensions of public employees.

Taxes can be defined as compulsory payments to a governmental entity in which the amount paid is not directly related to the cost of or benefits received from a service provided by the public jurisdiction. Examples of items which are directly related to a specific service and which are not considered as general taxes include benefit assessments for local improvement districts (LIDs or ULIDs) and payroll taxes levied upon employers for compensation to unemployed or injured workers.

The Census Bureau figures indicate that Washington state and local taxes totaled \$18.1 billion for fiscal year 1999. The largest source was the general sales and gross receipts tax category, which represented 46 percent of all state and local taxes in Washington. In addition to the state and local retail sales/use taxes, this category includes the state business and occupation tax and municipal business taxes since they are generally based on gross sales. (Few other states levy taxes measured by gross receipts, so the Census Bureau includes these in the general sales tax category.) The property tax was Washington's second largest tax source with 31.8 percent of all state and local taxes; it remained the most important local revenue source accounting for 62.4 percent of all local tax receipts.

**TABLE 1**  
**REVENUE OF STATE AND LOCAL GOVERNMENTS IN WASHINGTON<sup>1</sup>**  
Fiscal Year 1999 (Dollars in Millions)

<u>Source of Revenue</u>	<u>State Level</u>	<u>Local Level</u>	<u>Total</u>
<b>Taxes:</b>			
Property taxes	\$ 2,155.3	\$ 3,608.1	\$ 5,763.4
General sales taxes	7,253.6	1,072.4	8,326.0
Motor fuel taxes	717.8	0.4	718.2
Liquor taxes	159.7	-.-	159.7
Tobacco taxes	278.5	-.-	278.5
Utility taxes	261.1	292.6	553.7
Other sales taxes	389.5	271.7	661.2
Vehicle license taxes	273.3	119.9	393.2
Other taxes	848.6	415.5	1,264.2
Subtotal	12,337.6	5,780.5	18,118.1
<b>Current Charges:</b>			
Education	1,273.8	237.0	1,510.9
Hospitals	326.8	851.7	1,178.5
Sewerage/garbage	6.9	1,223.4	1,230.2
Other charges for service	398.0	1,237.9	1,635.8
<b>Federal Grants</b>	4,620.4	682.0	5,302.3
<b>Intergovernmental Transfers</b>	74.7	6,522.0	-.*
<b>Interest Earnings</b>	549.6	685.5	1,235.1
<b>Other General Revenue</b>	654.2	697.3	1,351.6
<b>Non-General Revenue:</b>			
Utility operations	-.-	3,488.4	3,488.4
Liquor store revenue	287.5	-.-	287.5
Employee retirement	5,795.1	285.5	6,080.6
Employee compensation	2,412.5	-.-	2,412.5
<b>TOTAL REVENUE</b>	<b>\$28,737.1</b>	<b>\$21,691.2</b>	<b>\$43,831.5*</b>

<sup>1</sup>Source: Bureau of the Census, U.S. Department of Commerce, State and local government Finances, 1998-99.

\* Duplicative intergovernmental transfers are excluded from the total.

State taxes accounted for 68 percent of all state/local taxes in Washington, while local government represented 32 percent. Washington's ratio of state taxes is much higher than many states (compared with 61 percent nationally) because Washington finances a greater proportion of governmental services at the state level, particularly funding of K-12, vocational, and community college education and public assistance programs.

There are three general types of taxes: property, income and excise. Property taxes consist of annual payments by owners of real property (land and structures) and personal property (tangible and intangible). Property taxes are measured by the value of the property (i.e., ad valorem tax) determined either by the fair market value or a statutory assessment formula.

Income taxes include the federal, state and local taxes measured by the annual income of individuals and corporations. Washington is one of seven states that does not levy a personal income tax upon households and one of four states – the others are Nevada, South Dakota and Wyoming - that do not impose any form of income tax (Alaska, Florida and Texas tax corporations but not individuals).

Excise taxes include virtually every other type of tax. Although there is not a single definition of excise taxes, generally these refer to a specified type of transaction or privilege. In Washington most excise taxes are measured by the selling price or some other measure of sales such as gross receipts. The retail sales tax is the single largest excise tax levied in this state. The major business tax is the business and occupation tax; although measured by gross "income", it is levied on the privilege of engaging in business and is categorized by the Census Bureau as an excise tax rather than an income tax. Other excise taxes include the selective sales taxes on specific products (cigarettes, gasoline, etc.) and the various taxes which are levied in lieu of property tax (e.g., harvested timber, leaseholds, etc.).

### State Government Revenues and Expenditures

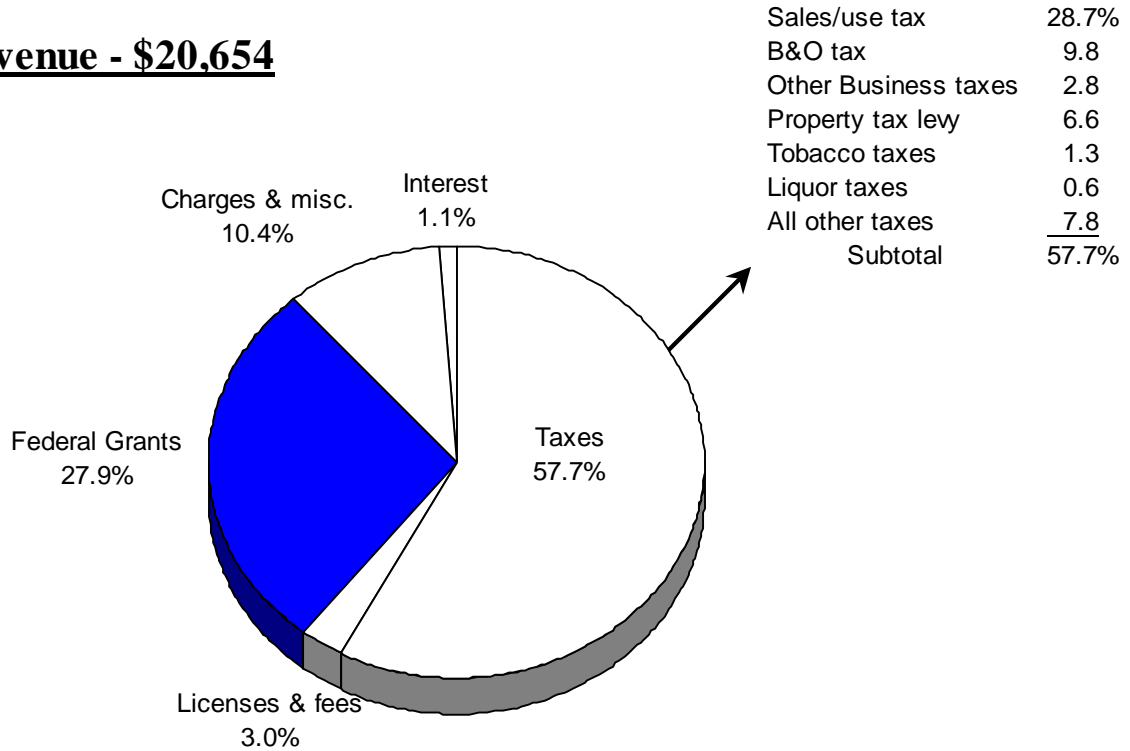
Data compiled by the Office of Financial Management and published in its Comprehensive Annual Financial Report form the basis for the state revenue and expenditure information shown in the following charts; local governments are not included in these data. The first set of charts reflects the revenues and expenditures for all state government funds; the following page shows the state general fund. The general fund is the source of funding for most programs which are not funded by dedicated revenue sources. Most transportation expenditures (and the fuel taxes and federal revenues which fund transportation) are outside of the general fund. Likewise, workers' compensation programs, which provide benefits to employees who become injured or unemployed, and pension programs of public employees are financed outside of the general fund.

# WASHINGTON STATE FINANCES

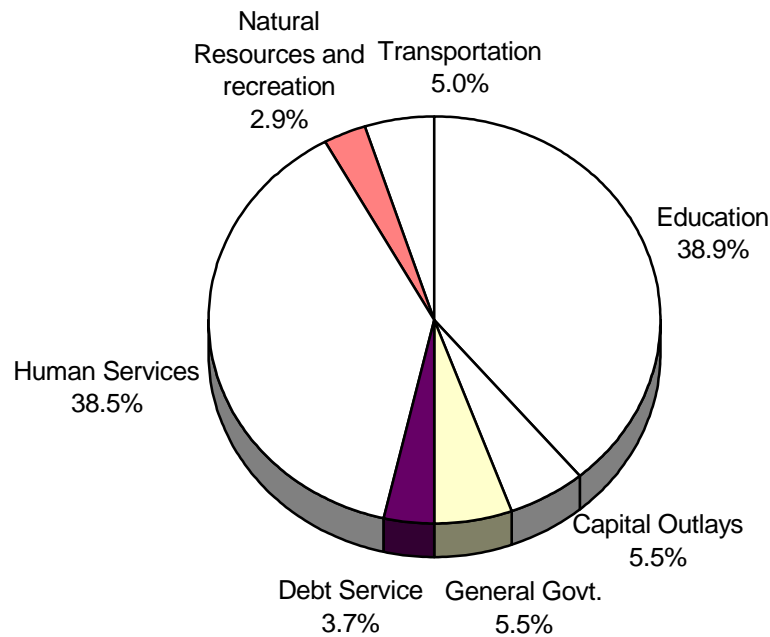
## Fiscal Year 2001

### All State Funds (\$ in millions)

#### Revenue - \$20,654



#### Expenditures - \$21,770

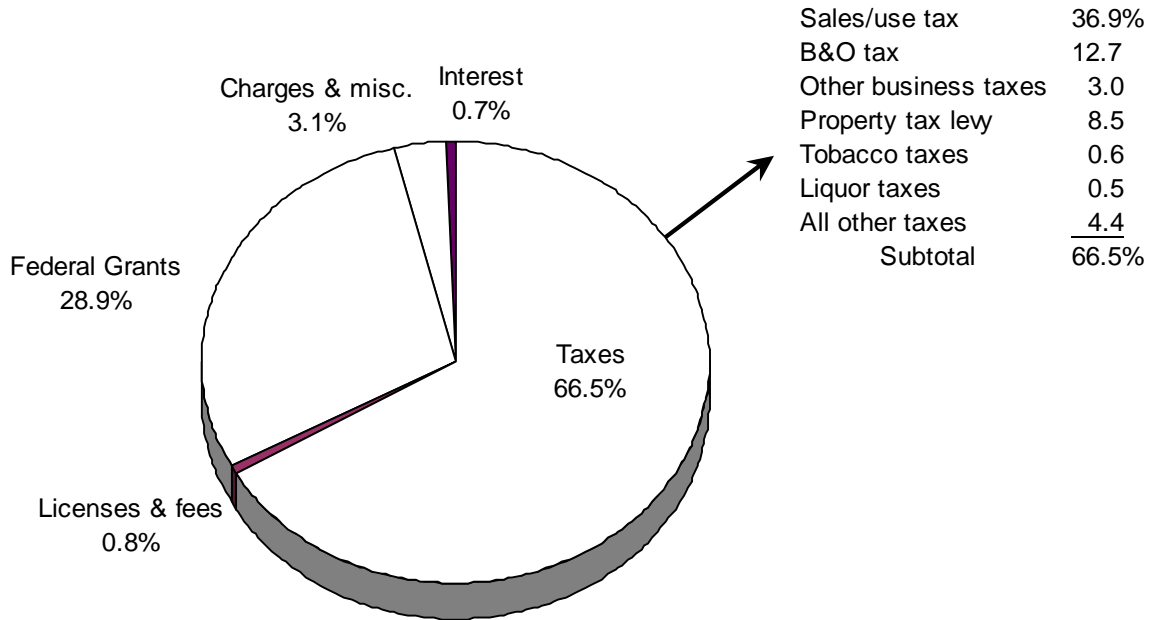


# WASHINGTON STATE FINANCES

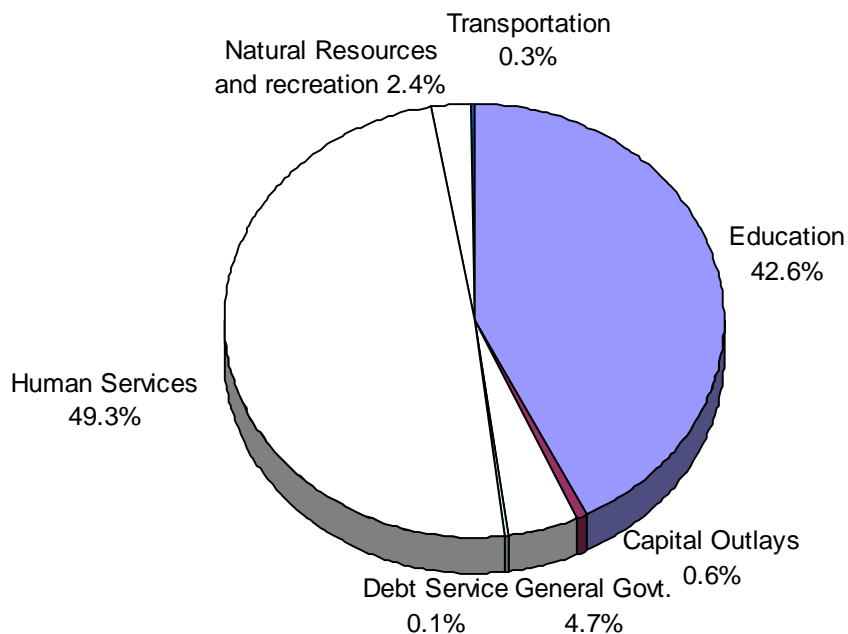
## Fiscal Year 2001

State General Fund (\$ in millions)

### Revenue - \$16,045



### Expenditures - \$15,523



For fiscal year 2001 total state revenues for all state government funds, excluding enterprise activities, amounted to \$20.7 billion. Taxes accounted for \$11.9 billion or 57.7 percent of the total. Receipts from the federal government constitute the other major category of state revenue; federal grants equaled \$5.8 billion and represented 27.9 percent of the total. Education, including support for K-12 schools and expenditures for public colleges and universities, accounts for 38.9 percent of all state expenditures. The other major state expenditure category was for human service programs; these represented 38.5 percent of state expenditures from all funds.

Washington State's general fund revenues exceeded \$16 billion for fiscal year 2001. Approximately 66.5 percent of the total was attributable to tax revenues, while federal grants represented nearly 29 percent. Within the tax category, the retail sales/use tax represented by far the largest source, accounting for 55.4 percent of state general fund taxes. The two other major state taxes were the business and occupation tax and the state property tax levy; these produced 19.0 and 12.8 percent respectively of state general fund tax revenues. Human services represents over 49 percent of general fund expenditures, while education comprises 42.6 percent of general fund programs. The cost of operating general state government programs, including most executive branch agencies, the Legislature, state judicial expenses, licensing and regulation activities, financial administration and a variety of other general administration functions--amounted to 4.3 percent of general fund expenditures.

### Net Washington State Tax Collections

Further detail on taxes collected for state purposes is shown in Table 2, according to information compiled by the various tax-collecting agencies. The data in this table are consistent with the amounts indicated for each particular state tax source in the body of this report; however, the figures may be slightly different than those reported by the Office of Financial Management or by the Census Bureau due to differences in definitions (e.g., the Census Bureau includes a variety of license fees as miscellaneous tax revenues) and because some of the reported revenues may be on the basis of cash collections and others may represent accrued tax liability (GAAP basis).

The total of all state taxes covered in this manual for fiscal year 2001 was \$11.9 billion, an increase of only 0.6 percent over the fiscal year 2000 amount. The principal reason for the low growth rates was that FY 2000 still included a residual \$330 million of motor vehicle excise tax revenues. By FY 2001 all MVET receipts had disappeared as a result of repeal of the tax effective on January 1, 2000. Omitting repealed vehicle excises, the 2001 growth rate in total state taxes was 3.5 percent.

As seen in Table 2, by far the largest state tax source is the retail sales tax which totaled \$5.5 billion. Together with its companion use tax, the sales/use tax represents 49.9 percent of total state tax collections. In second place was the business and occupation tax with 17.0 percent of the total. The third largest state source was the state property tax levy; it produced 11.5 percent of state tax revenues. In fourth place among state tax sources was the motor vehicle fuel tax; together with the special fuel tax these sources produced 6.2 percent of total state taxes.

**TABLE 2**  
**NET WASHINGTON STATE TAX COLLECTIONS\***  
**Fiscal Years 2000 and 2001 (\$ in thousands)**

<u>Tax Source</u>	<u>Fiscal 2000</u>	<u>Fiscal 2001</u>	<u>% Change</u>	<u>2001 % of Total</u>
<b>General/Selective Sales Taxes</b>				
Retail sales	\$5,405,602	\$5,519,106	2.1%	46.5%
Use	383,796	401,326	4.6	3.4
Cigarette	250,109	244,550	(2.2)	2.1
Tobacco products	23,894	25,420	6.4	0.2
Liquor sales	53,756	57,389	6.8	0.5
Liquor liter	65,811	67,561	2.7	0.6
Wine	15,163	15,235	0.5	0.1
Beer	28,268	30,136	6.6	0.3
Motor vehicle fuel	636,198	611,723	(3.8)	5.2
Special fuel	125,955	114,655	(9.0)	1.0
Aircraft fuel	1,632	1,966	20.5	0.0
Convention center	33,132	40,254	21.5	0.3
Solid waste collection	23,237	25,003	7.6	0.2
Wood stove	243	233	(4.1)	0.0
Brokered natural gas	14,835	30,669	106.7	0.3
Rental car	21,111	22,032	4.4	0.2
Enhanced 911 telephone	9,588	11,734	22.4	0.1
<b>General/Selective Business Taxes</b>				
Business & occupation	1,854,948	2,012,403	8.5	17.0
Public utility	246,383	267,624	8.6	2.3
Insurance premiums	260,949	279,777	7.2	2.4
Food fish/shellfish	1,481	1,437	(3.0)	0.0
Hazardous substance	49,472	72,455	46.5	0.6
Soft drinks syrup	9,901	9,278	(6.3)	0.1
Petroleum products	--	--	--	--
Oil spill	5,664	5,955	5.1	0.1
Litter	5,851	5,926	1.3	0.1
Parimutuel	2,030	2,019	(0.5)	0.0
Boxing/wrestling	9	43	377.8	0.0
IMR	8,396	7,867	(6.3)	0.1
<b>Property &amp; In-lieu Taxes</b>				
State levy	1,328,690	1,367,696	2.9	11.5
Motor vehicle excise	330,121	---	--	--
Aircraft excise	226	222	(1.8)	0.0
Watercraft excise	11,204	11,413	1.9	0.1
Travel trailer/camper excise	2,690	---	--	--
Timber excise	20,154	15,161	(24.8)	0.1
PUD privilege	28,894	29,907	3.5	0.3
Leasehold excise	16,567	17,048	2.9	0.1
<b>Other Taxes</b>				
Real estate excise	435,088	434,310	(0.2)	3.7
Estate & transfer	82,705	107,097	29.5	0.9
<b>TOTAL</b>	<b>\$11,793,753</b>	<b>\$11,866,630</b>	<b>0.6%</b>	<b>100.0%</b>

\*Excludes local taxes and state payroll taxes for workers' compensation programs.

## Initiative 601 Limit on State Expenditures and Tax Increases

In November, 1993, the voters of Washington approved Initiative 601 (Chapter 43.135 RCW). This measure limits the amount which state government may spend from the general fund and also imposes a supermajority voting requirement on increases in state taxes. It replaced another limitation mechanism, Initiative 62, which was approved by the voters in 1979; this had limited the growth in state revenues to the growth rate in state personal income.

### SPENDING LIMITATION

The 601 spending limitation prohibits the expenditure of state general fund revenues above a certain level that is determined by formula. The expenditure limit became effective on July 1, 1995 and therefore first affected expenditures during fiscal year 1996. The calculation was originally based on general fund state expenditures which occurred during FY 1990; to this amount was applied the fiscal growth factor each year and certain adjustments to produce the maximum level of expenditure for FY 1996. Starting with expenditures in FY 1998, the limit has been based on prior actual state general fund expenditures rather than the maximum calculated level. The annual fiscal growth factor consists of the sum of the percentage change in state population and inflation (measured by the implicit price deflator) which are averaged over the three previous fiscal years. The growth factors for FY 2002 and 2003 have been determined to be 2.79 and 3.29 percent respectively for each year of the 2001-03 Biennium.

As required by the initiative, the limit must be adjusted when program costs or revenues are transferred into or out of the general fund.

Because the expenditure limit applies on a fiscal year basis, determining the amount of appropriations within the biennial state budget must now be done on an annual basis so that the limit for individual fiscal years is not exceeded. Each November, the Expenditure Limit Committee (consisting of the Director of the Office of Financial Management, the Attorney General, and the chairs of the House and Senate fiscal committees) adjusts the limit for the previous fiscal year to reflect the actual level of expenditures which occurred. It then forecasts the limit amount for succeeding years. The expenditure limits for each year of the current 2001-03 biennium and the ensuing 2003-05 biennium are shown below:

Fiscal Year 2002	\$11,251.5 million
Fiscal Year 2003	\$11,664.8 million
2001-03 Biennium	\$22,916.3 million
Fiscal Year 2004	\$12,043.9 million
Fiscal Year 2005	\$12,422.0 million
2003-05 Biennium	\$24,465.9 million

If revenues from the existing tax structure exceed the expenditure limit, the excess is deposited into an emergency reserve fund. This fund is limited to an amount equal to five percent of the state revenues in the general fund. If that balance is equaled, the excess funds are then transferred to an education construction fund to be used for K-12 schools and higher education construction. The emergency reserve fund may only be utilized with a two-thirds vote of both houses of the Legislature and only up to the overall expenditure limit.

The initiative requires that any shifts of revenue sources or programs out of the general fund will require a commensurate reduction in the expenditure limit. Likewise, it requires that local governments be compensated by the state for any new programs or expanded services they are required to perform by the Legislature. If program responsibility is shifted to or from the state to local jurisdictions or the federal government, the state expenditure limit shall be changed accordingly.

## VOTING REQUIREMENTS FOR TAX INCREASES

Initiative 601 also limits the manner in which state revenue may be increased. Starting on July 1, 1995 any measure which increases state revenues or results in revenue-neutral tax shifts may only be adopted if two-thirds of the members of both houses of the Legislature approve. Further, the increased revenues must not result in expenditures above the spending limit. If the additional revenues will cause the limit to be exceeded, then the measure must also be approved by a simple majority vote of the statewide electorate. The initiative allows temporary tax increases to combat the effects of natural disasters for up to 24 months upon declaration of an emergency by the Governor and a two-thirds vote of the Legislature; no referral to the voters is required for such emergencies.

### Comparisons with Other States

No other state relies so heavily on sales taxes as does Washington. The reliance on general sales taxes in Washington is nearly twice the national average: 46.0 percent versus 24.6 percent. (The Census Bureau includes Washington's B&O tax in the general sales category, since it is measured by gross sales.) Including taxes on the sale of specific goods, the overall general sales tax category accounts for 59 percent of state and local taxes in Washington. Balancing the heavy reliance on sales taxes is the absence of an individual or corporate net income tax, which produces an average of 27.4 percent of total tax revenues in other states. Property taxes represent 31.8 percent of total taxes in Washington; this is slightly above the national average reliance of 29.4 percent.

Table 3 illustrates the utilization of major state and local tax sources in Washington compared with the national average for the latest year that comparable data are available.

**TABLE 3**  
**PERCENTAGE RELIANCE ON MAJOR STATE/LOCAL TAXES**  
Washington State and National Average  
Fiscal Year 1999

<u>Tax Source</u>	<u>Washington</u>	<u>All States</u>
General sales taxes*	46.0%	24.6%
Selective sales taxes	13.1	11.1
Property taxes	31.8	29.4
Income taxes	-.-	27.4
All other taxes	9.1	7.5
<b>TOTAL</b>	<b>100.0%</b>	<b>100.0%</b>

\*includes retail sales/use and gross receipts taxes.

Source: State and Local Government Finances in 1998-99, Bureau of the Census.

There are two principal methods for measuring tax burdens among the states. The first simply divides the total tax collections by the population of a state to obtain a per capita figure. (The calculation usually includes taxes paid by businesses, since it is not possible to separately identify business tax payments for all tax sources; in any case these are often assumed to be passed on to individual consumers.) Based on the latest available data (fiscal year 1999), Washington state and local taxes per capita amounted to \$3,148. This statistic ranked 13th from the highest among all states in tax burden and was 5.2 percent above the national average of \$2,992.

However, because there are significant differences among individual residents of the state, the per capita method only produces meaningful data for persons who are "average" in terms of income and other relevant criteria such as age, family size, geographical location, etc. For example, the household tax burden for a very large family may not simply be the statewide per capita amount multiplied by the number of persons in the family, since the tax burden attributable to children is likely somewhat lower than for adults. Likewise, actual taxes might be higher for persons during their household formation years (making purchases of a residence, household goods, etc.) than in retirement years. Further, there are significant differences in personal income among states, and hence they do not all have the same ability to finance government services.

Washington's tax system is driven largely by consumption and consumption depends most directly upon income. Thus, comparing tax burdens to income yields a more representative tax burden indicator for most households. Total tax collections divided by a state's aggregate personal income (a statistic developed by the Bureau of Economic Analysis of the U.S. Department of Commerce) produces such a comparison. In fiscal year 1999 Washington's state and local taxes amounted to \$111.25 per \$1,000 of personal income. This compared with the national average of \$110.48 and ranked 20th from the highest in overall tax burden.

Table 4 provides a recent history of Washington's comparative tax burden. The table shows that tax burdens were relatively lower during the early 1980s as the recession impacted Washington more severely than many states. The income comparison indicates that Washington tax burdens reached an all-time low in 1981, when state and local taxes were higher in 37 other states. Tax burdens returned to more typical levels during the remainder of the decade, as Washington's economy rebounded relative to other states and per capita personal income returned to previous levels. During most of the 1990s the tax rankings for Washington were at all-time high levels, ranking as high as 9<sup>th</sup> by the income measure and 10<sup>th</sup> on the per capita basis. In the latest several years Washington's tax ranking have moderated, due to the repeal of tax increases enacted in 1993, the impact of Initiative 601 in restraining state expenditure growth, and Referendum 47 which limited the growth in property taxes. Further significant reductions in the tax rankings are expected in FY 2000 and 2001 when repeal of the motor vehicle excise tax is reflected in the data.

**TABLE 4**  
**WASHINGTON TAX BURDEN SINCE 1980**  
 State/Local Taxes in Relation to Population and Personal Income

<u>Fiscal Year</u>	<u>Per Capita</u>		<u>Per \$1,000 Income</u>	
	Amount	Rank	Amount	Rank
1999	\$3,148	13	\$111.25	20
1998	3,038	13	115.00	17
1997	2,916	11	117.49	11
1996	2,795	10	119.79	12
1995	2,728	10	123.00	11
1994	2,596	10	121.24	15
1993	2,431	10	117.95	17
1992	2,326	12	122.17	11
1991	2,236	11	121.75	9
1990	2,123	11	122.98	10
1989	1,910	15	118.76	15
1988	1,783	16	117.04	16
1987	1,697	15	114.99	19
1986	1,589	14	113.89	16
1985	1,435	18	108.47	25
1984	1,416	13	112.85	21
1983	1,306	13	109.22	16
1982	1,172	20	98.27	32
1981	1,037	21	96.18	38
1980	989	19	103.41	30

Source: State and Local Government Finances, Bureau of the Census, U. S. Department of Commerce.